Journal of International Conference Proceedings (JICP)
Vol. 7 No. 5, pp. 1196-1204, February, 2025
P-ISSN: 2622-0989/E-ISSN: 2621-993X
https://www.ejournal.aibpmjournals.com/index.php/JICP

Impact of Information Disclosure on Banking Risk

Novita Febriany[1,2], Taufiq Marwa[1], Suhel[1], Hasni Yusrianti[1]
[1]Doctoral program in Accounting, Faculty of Economics, Sriwijaya University, Inderalaya, 30662, Indonesia
[1,2]Departemen of Accounting, Faculty of Business and Accounting, Musi Charitas Catholic University, Palembang, 30113, Indonesia
*Corresponding Email: novita@ukmc.ac.id

ARTICLE INFORMATION

Publication information

Research article

HOW TO CITE
Febriany, N., Marwa, T., Suhel, & Yusrianti, H. (2025). Impact of information disclosure on banking risk. *Journal of International Conference Proceedings,* *7*(5), 1196-1204.

DOI:
https://doi.org/10.32535/jicp.v7i5.3682

Received: 28 December 2024
Accepted: 24 January 2025
Published: 26 February 2025

ABSTRACT

This study examines the impact of information disclosure on the management of banking risks based on previous research. Various studies show that better disclosure in financial reports can reduce the uncertainty faced by external parties such as investors, regulators, and creditors, as well as improve the efficiency of risk management by the bank's management. This study explains that transparency can strengthen the trust relationship between the bank and its customers, and can minimize risk management in decision-making. On the other hand, lack of transparency or insufficient disclosure can increase uncertainty and may lead to higher risks in decision-making, which can ultimately affect the financial stability of the bank. Increasing transparency in the disclosure of both financial and non-financial information is expected to help reduce bank risks and enhance the overall stability of the financial system.

Keywords: Banking Risk; Financial Transparency; Information Disclosure; Risk Management.

INTRODUCTION

The banking sector has undergone significant transformation in recent years, driven by changes in regulations, technology, and risk management practices. With the ongoing development of the global economy and the rapid rise of digitalization, the banking sector is expected to face new challenges in improving transparency and managing risks more effectively. One key aspect of this is transparency, particularly in terms of the disclosure of risk and sustainability information, which has become a central focus in banking regulations for 2024.

Globally, transparency in the banking sector has become a primary concern for regulators and stakeholders. The increased disclosure of risk and financial performance in banks' annual reports is expected to strengthen the stability of the banking sector and build greater trust among customers and investors. According to the April 2024 Global Financial Stability Report from the International Monetary Fund (IMF), transparent risk management, based on accurate data, can reduce market uncertainty and mitigate systemic risks that could destabilize the global banking sector, including in Indonesia (IMF, 2024). The banking sector also faces similar challenges, including rising global uncertainty, climate change risks, and the rapid technological advancements, such as digital banking and fintech, which are playing an increasingly significant role in the banking system.

Transparency and Disclosure (T&D) of information are crucial in managing banking risks. In developing countries, particularly in Asia, better information disclosure enables stakeholders, including investors and regulators, to make better and faster decisions, reducing market uncertainty. As attention to banking risks grows, improved disclosure of information is expected to enhance financial stability and mitigate risks faced by banks, both in conventional and Islamic banking sectors.

In the banking sector, transparency and disclosure (T&D) play a vital role in maintaining financial system stability. Higher levels of disclosure can increase market confidence and reduce uncertainty, which, in turn, can reduce the risks faced by banks (Setiyono & Tarazi, 2014). However, the impact of disclosure on risk management and bank performance often depends on the ownership structure of the bank and the specific characteristics of the markets in which they operate. This study aims to analyze how transparency and disclosure of information impact banking risk and performance across regions such as Asia, Europe, and India. Lindsey and Goddard (2017) assert that good corporate governance can improve financial performance, including in the banking sector, by enhancing transparency and risk management. Zhong, Song, and Lee (2023) found that transparency in supply chains can help better manage crash risks by increasing market trust and improving financial system stability.

Several previous studies explain the positive relationship between transparency and disclosure with better risk management in banks. Setiyono and Tarmizi (2014) found that more open ownership structures and tighter supervision can improve disclosure, positively impacting banking risk. Tadesse (2006) found that well-regulated disclosure can provide economic value to the banking sector by enhancing market trust and reducing information asymmetry. On the other hand, Srairi (2019) found that in Islamic banks, risk management is more conservative due to Sharia principles that avoid excessive risks, which can influence the level of disclosure provided by these banks. In line with this, Mollah & Lipy (2018) stated that Islamic banks prioritize caution in risk management, contributing to more stable risk management and greater financial system stability. Meanwhile, Berger and Turk-Ariss (2015) stated that more stringent disclosure

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regulations play a key role in improving performance and market confidence in both Islamic and conventional banks.

Despite the numerous studies showing the importance of transparency in banking risk management, there is still a gap in the literature connecting information disclosure with its impact on the risks faced by Islamic banks compared to conventional banks. This research aims to explore the impact of transparency and disclosure on banking risks and performance, focusing on the comparison between Islamic and conventional banks. The study will also analyze the role of stress tests in enhancing transparency and risk management in both types of banks.

LITERATURE REVIEW

Transparency and information disclosure in the banking sector have become a key focus in several studies. Clear and transparent disclosure regarding the bank's financial position, risk management, and supervisory policies has a significant impact on banking system stability and bank performance. Furthermore, ownership structure and regulatory frameworks also play an important role in enhancing transparency, which ultimately affects risk management in banks. Jensen and Meckling (1976) explain that ownership structure, which influences managerial behavior, can increase agency costs, which in turn affects decision-making within firms. Setiyono and Tarazi (2014) state that more open ownership structures and tighter supervision can improve the level of information disclosure by banks. Banks that are more transparent about the risks they face tend to have lower risks, as investors and regulators make more informed decisions. Tadesse (2006) suggests that higher levels of disclosure in financial reporting and risk management can reduce uncertainty and enhance banking stability. In conventional banks, higher disclosure reduces the likelihood of moral hazard and enhances market discipline (Nier & Baumann, 2006).

Khammassi et al. (2023) explain that stress tests can enhance bank transparency by providing a clearer picture of a bank's ability to withstand extreme conditions, such as financial crises or significant market fluctuations. Disclosing the results of stress tests allows investors to assess a bank's resilience to economic crises and systemic risks, thereby improving market confidence in the bank's stability. Banks that regularly conduct stress tests and disclose the results tend to manage risks more effectively and have more stable performance.

Tadesse (2006) argues that stricter disclosure regulations can provide economic value to the banking sector by enhancing market confidence and reducing information asymmetry. Regular and systematic disclosure allows banks to be more transparent about their financial positions and the risks they face, which can reduce market uncertainty. Nier & Baumann (2006) add that transparency in disclosure reduces moral hazard, which refers to the tendency to take higher risks once it is known that losses can be borne by third parties. Therefore, better disclosure facilitates greater market discipline, which ultimately reduces systemic risk in the banking sector.

Srairi (2019) found that Islamic banks, which operate based on Sharia principles, tend to be more conservative in their risk management compared to conventional banks. The precautionary principles applied in Islamic banks result in greater risk reduction and enhance market confidence, as Islamic banks are generally more cautious in managing risks.

Rastogi (2024) found that in India, better information disclosure can improve market valuation of banks and enhance their performance, especially amid global economic uncertainty. This finding aligns with the study by Rawal et al. (2023), which shows that more transparent disclosure helps improve market perception of banks facing financial difficulties. However, providing higher levels of disclosure regarding financial conditions and risk mitigation measures can help improve market perception and increase the market value of banks, even amid financial distress.

The Impact of Ownership Structure on Disclosure and Bank Risk According to Altunbas, Khan, and Thornton (2022), they found that banks with different ownership structures can influence the level of information disclosure by the bank. Banks with more open ownership structures and tighter supervision tend to have higher levels of transparency, which positively affects risk management and financial performance.

RESEARCH METHOD

This study employs a qualitative research design through a systematic literature review approach to analyze the relationship between information disclosure, transparency, and banking risk. The research focuses on identifying, evaluating, and synthesizing relevant academic literature published between 2010 and 2024, which discusses the impact of information disclosure on banking risk, ownership structure, regulatory frameworks, and financial stability.

To ensure the quality and relevance of the literature, journal articles were selected based on the following inclusion criteria: (1) peer-reviewed publications; (2) focused on banking or financial institutions; (3) discussed at least one of the key themes—information disclosure, transparency, ownership structure, or banking risk; and (4) published in reputable databases such as Scopus, Web of Science, ScienceDirect, and Google Scholar.

The data collection process involved keyword-based searches using terms such as "information disclosure," "banking risk," "transparency in banking," "ownership structure," and "financial stability." Selected articles were reviewed, categorized thematically, and compared to identify common findings, methodological patterns, theoretical frameworks, and gaps in the literature.

The analysis was conducted through content analysis and thematic coding to extract major themes, assess methodological approaches, and evaluate the impact of disclosure practices on banking risk under different regulatory environments. This method allows for a comprehensive understanding of the evolution of the discourse and provides insights into the implications of information disclosure for banking institutions across various financial systems.

RESULTS

This study analyzes the impact of transparency and information disclosure on banking risks and bank performance in the banking sector, focusing on a comparison between Islamic banks and conventional banks in Asia and India. Higher transparency related to information disclosure is positively associated with better bank performance. More comprehensive disclosure regarding the risks faced by banks, including credit risk, market risk, and liquidity management, has been shown to improve Return on Assets (ROA) and Return on Equity (ROE). These findings align with Setiyono and Tarazi (2014), who demonstrated that higher disclosure in the banking sector in Asia can reduce risks and improve bank performance. Banks that are more transparent tend to have lower Non-Performing Loan (NPL) ratios, which can indicate better credit management. This supports the idea that greater disclosure reduces market uncertainty and helps banks manage systemic risks (Tadesse, 2006).

Banks facing financial difficulties, such as high levels of non-performing loans or low capital adequacy, tend to have lower market valuations. This result is consistent with Rawal et al. (2023), who showed that financial distress lowers investor confidence, causing banks in financial trouble to experience a decline in market valuation. Better disclosure of financial risks and the risk mitigation steps taken by banks can improve market perception of banks experiencing financial difficulties. As a result, banks that are more transparent in disclosing financial difficulties tend to improve their market valuation. Islamic banks are found to be more conservative in risk management compared to conventional banks. According to Srairi (2019), Islamic banks, which operate based on Sharia principles, are more cautious in taking risks, leading to better risk management and more stable performance. Islamic banks tend to be more open in disclosing information related to risks and are more transparent in their financial reporting, which enhances market confidence in their stability. Conventional banks have more disclosures related to risk management, but sometimes these relate to free- market risks and economic crises, which make conventional banks more vulnerable to market fluctuations. This is in line with the findings of Bitar & Mokhtar (2020), who concluded that banks with higher disclosure tend to be more stable, whether in the Islamic or conventional banking sector, with the difference lying in risk management policies. According to Mollah & Lipy (2018), Islamic banks prioritize precaution in risk management, contributing to more stable risk management and better financial system stability. Abedifar, Molyneux, and Tarazi (2013) stated that Islamic banks tend to avoid excessive risks and have more transparent risk management policies, making them more financially stable compared to conventional banks, while Tadesse (2006) indicated that good information disclosure can reduce moral hazard and enhance bank financial stability.

Banks that regularly conduct stress tests and disclose the results to the public have higher levels of disclosure regarding their financial condition and the risks they face. This finding supports Khammassi et al. (2023), who stated that transparent stress tests can increase market confidence in banks, as they allow investors to assess a bank's resilience to market shocks. Disclosure of stress test results enables regulators to assess systemic risks that large banks may pose and prevent broader systemic crises. By providing better disclosure, stress tests can help reduce systemic risks and enhance the overall stability of the banking sector.

Rastogi (2024) shows that banks in India with higher levels of disclosure tend to have higher ROA and ROE. More transparent disclosure regarding market risks, liquidity management, and capital reserves is associated with improved performance and better risk management, thereby supporting financial system stability in emerging economies. Stricter disclosure regulations have been proven to enhance market discipline and reduce moral hazard, ultimately leading to a reduction in systemic risks. This study is consistent with the findings of Barth, Caprio Jr., and Levine (2004), who stated that stricter disclosure regulations can help stabilize the banking sector and reduce the potential for financial crises.

Rinaldi & Prihatiningtias (2024), the important role of well-designed regulations and policies in improving risk management practices. Effective regulation creates a structured framework, encouraging transparency and accountability that improves organizational performance. A clear regulatory framework provides organizations with the right guidelines for managing risk. Increased transparency and accountability ensure that all stakeholders are accountable for their Actions. Regulations and policies that shape the perception of risk contribute to more informed and strategic decision- making, which ultimately improves the effectiveness of risk management and the success of the organization.

Alessandro et al (2023), explain that to recognize the performance of companies-Companies that emphasize more social and responsible investment, especially in banking that have operational, idiosyncratic, and systemic ratios. If banks can implement prudent operations from their operations in distributing funds, it can lead to financial inclusion to the public, especially state-owned banks in improving financial services in Indonesia. The importance of transparency and accountability in financial institutions, especially banking in Indonesia. So this research can be used to highlight how transparency practices can mitigate financial risks and improve the stability of the banking sector.

Darmansyah et al (2024), good corporate governance practices can contribute to achieving organizational goals by applying risk management at the level of individual activity and functional areas. This study analyzes the influence of corporate governance, regulatory compliance, and Company size on the Company's risk management in regional development banks in Kalimantan. Every Company that experiences business instability or ups and downs, risk management is needed in the process. The risk management process will affect governance which will have a direct impact on the composite value of a company (Nisa, 2020). Accountability is one of the main pillars of good corporate governance (GCG) so as to encourage data-driven and risk-based decision-making, thereby minimizing irregularities and strengthening banking stability.

Effective corporate governance is seen as able to improve the performance of Enterprise Risk Management because management feels systematically responsible for the decisions and risks taken. The practice of accountability in corporate governance and transparency through compliance regulations directly contribute to the success of the banking risk management system, both of which strengthen the foundation of an institution that will be able to control, control, and respond to financial risks systemically. The role of strong accountability and transparency will not only have an impact on internal risk control, but also create a healthier, more stable and sustainable banking system.

DISCUSSION

This study finds that higher levels of information disclosure reduce banking risks and improve bank performance. More transparent disclosure provides a clearer picture of the bank's financial position and the risks it faces, helping to reduce market uncertainty and enhance investor confidence. This aligns with the findings of Setiyono and Tarazi (2014), who stated that higher disclosure is associated with better risk management and greater financial stability.

Islamic banks exhibit more conservative and transparent risk management, resulting in greater stability in the face of market shocks compared to conventional banks. Sharia-based risk management encourages the avoidance of excessive risks, which strengthens market confidence and reduces systemic risks. In contrast, conventional banks tend to be more exposed to free-market risks, even though they have more disclosures related to risk management (Srairi, 2019).

Transparent stress tests have been shown to help reduce market uncertainty and improve investor confidence in the stability of banks. This indicates that stress testing is not only a tool for assessing a bank's resilience to economic shocks but also functions as a risk mitigation tool that helps lower systemic risk (Khammassi et al., 2023).

Financial difficulties have a negative impact on market valuations of banks, according to Rawal et al. (2023). They stated that better disclosure regarding financial positions and risk mitigation measures can help improve market perception of banks, even when banks are facing financial difficulties. Higher levels of disclosure regarding risks and financial conditions can help improve the financial stability of banks.

CONCLUSION

This study shows that transparency and information disclosure play a crucial role in reducing banking risks and improving bank performance. Better disclosure helps manage risks, enhance financial stability, and improve market confidence in banks. Meanwhile, Islamic banks demonstrate better and more transparent risk management compared to conventional banks, particularly in relation to free-market risks. Additionally, the use of transparent stress tests has also been shown to increase market confidence and improve financial system stability.

ACKNOWLEDGMENT
The author would like to thank the International Project Management Conference for the opportunity to participate in the International Project Management Conference in Bali (ICPM) 2024. The author would also like to express gratitude to Musi Charitas Catholic University and Sriwijaya University for the opportunity provided.

DECLARATION OF CONFLICTING INTERESTS
The author declares that there are no conflicts of interest related to the publication of this research, except for the support provided by Musi Charitas Catholic University and Sriwijaya University. This support did not influence the research design, data collection, analysis, or interpretation of the results.

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ABOUT THE AUTHOR(S)

1st Author
Novita Febriany is a lecturer in the Department of Accounting, Faculty of Economics and Business, Universitas Katolik Musi Charitas, Indonesia. She holds a Bachelor's degree in Economics from Universitas Sriwijaya (2009) and a Master's degree in Islamic Studies from Universitas Sriwijaya (2013). Currently, she holds the academic position of Lektor (Assistant Professor) and serves as a permanent faculty member actively engaged in teaching and research in the field of accounting. Her research interests include corporate governance, capital structure, and financial performance. She has authored several studies on corporate finance and performance indicators such as the Wealth Added Index (WAI). Email: novita@ukmc.ac.id

2nd Author
Taufiq Marwa is a Professor in the Department of Economics, Faculty of Economics, Universitas Sriwijaya, Indonesia. He earned his Bachelor's degree in Economics from Universitas Sriwijaya in 1992, a Master of Science degree from Universitas Syiah Kuala

in 1996, and a Doctoral degree in Economics from Universitas Padjadjaran in 2001. With extensive experience in the field of economics, his academic interests include banking stability, financial economics, and development economics. He is actively involved in teaching and research, and currently serves as a permanent faculty member. One of his recent research works includes Loan Portfolio, Capital, and Bank Stability: Evidence from Emerging and Developing Countries (2023).

3rd Author
Suhel is an Associate Professor in the Department of Economics, Faculty of Economics, Universitas Sriwijaya, Indonesia. He holds a Doctorate in Economics from Universitas Padjadjaran (2012), a Master of Science in Economics from Universitas Syiah Kuala (1998), and a Bachelor's degree (Doktorandus) from Universitas Jenderal Soedirman (1991). With a strong academic background in industrial economics, poverty alleviation, and microenterprise development, he has been actively engaged in teaching and research. His recent research includes Cost Structure, Industrial Concentration, and Price-Cost Margin of Indonesia’s Manufacturing Industry (2023). He currently serves as a permanent faculty member at Universitas Sriwijaya.

4rd Author
Hasni Yusrianti is a female lecturer and Head Lecturer (Lektor Kepala) in the Department of Accounting at Universitas Sriwijaya, Indonesia. She holds a Doctoral degree (S3) from Universitas Diponegoro, completed in 2020, a Master’s degree in Accounting and Controlling from Haagse Hogeschool obtained in 2011, and a Bachelor’s degree in Economics from Universitas Sriwijaya earned in 1997. Currently, she serves as a permanent academic staff member actively engaged in teaching and research at Universitas Sriwijaya. Her research interests include fiscal decentralization, sustainability reporting, environmental and social governance, audit quality, and corporate governance. Hasni Yusrianti has contributed to numerous research projects, such as studies on corruption and intergovernmental revenue, carbon pricing policy impacts, and audit fee dynamics during the pandemic. She is committed to advancing accounting science through empirical and applied research.